



A New Generation of Energy

July 25, 2008

The Honorable Arnetta McRae
Commission Chair
Delaware Public Service Commission
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Cannon Building, Suite 100
Dover, Delaware 19904

The Honorable Russell T. Larson
Controller General
Office of the Controller General
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The Honorable Jennifer Wagner Davis
Director
Office of Budget and Management
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The Honorable John A. Hughes
Secretary
Department of Natural Resources and
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89 Kings Highway
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Re: PSC Docket Nos. 06-241 and 07-20

Dear Chair McRae, Director Davis, Controller General Larson and Secretary Hughes:

In their Findings, Opinion and Order No. 7199, dated May 22, 2007, the State Agencies adopted the "Hybrid Approach" under which Delmarva Power & Light Company ("Delmarva") would purchase off-shore wind based power from Bluewater Wind ("Bluewater") and back up on-shore gas fired power from either Conectiv Energy Supply, Inc. ("CESI") or NRG. On September 14, 2007 Delmarva filed a term sheet negotiated with Bluewater for 300 MW of off-shore wind power and term sheets negotiated with CESI and NRG for back-up power from an on-shore facility (the "Gas Back-up Facility").

On June 23, 2008 Delmarva and Bluewater jointly filed an executed Power Purchase Agreement ("Wind Power PPA") under which Delmarva will purchase 200 MW of wind power generation. At a hearing on July 8, 2008, the State Agencies directed interested parties to submit comments, by July 25, 2008, on the Wind Power PPA and on

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the process for further consideration of the Gas Back-up Facility. This correspondence is provided in response to that directive.

CESI based its back up service term sheet ("CESI's Back-up Proposal") upon use of two GE 100 MW LMS 100 units that are specifically designed to meet the back-up service requirements of the wind power generation. NRG based its term sheet upon a 300 MW combined cycle generation facility.

The October 29, 2007 Staff Report, based upon the State Agencies' outside consultant's report, found that adoption of CESI's Back-up Proposal would be \$74 million less expensive than adoption of NRG's proposal. CESI now has every reason to conclude that it has submitted the winning bid in the competitive bidding process conducted by the State Agencies. CESI stands ready, willing and able to conduct final negotiations with Delmarva within the context of PSC Docket No. 06-241 (the "RFP Proceeding") that will lead to execution of an agreement for back up power supply that incorporates the terms of CESI's Back-up Proposal.

If consideration of the Gas Back-up Facility is deferred to PSC Docket No. 07-20 (the "IRP Proceeding") the Commission is likely to shift its focus away from the Gas Back up Facility contemplated by the Hybrid Approach. Instead, it will consider the need for the Gas Back-up Facility within the context of Delmarva's overall power supply requirements. Such consideration could lead to a determination that the Gas Back-up Facility, as initially contemplated under the Hybrid Approach, does not fit within Delmarva's overall power needs. Alternatively, even if the Commission finds that some form of Gas Back-up Facility is needed for southern Delaware, it may decide that there is no longer any reason to limit bids for the Gas Back-up Facility to CESI and NRG. Instead, in an effort to obtain the lowest competitively priced wholesale power for Delmarva's customers, the Commission may direct Delmarva to open up the bid process to all potential gas generation suppliers.

Notwithstanding the fact that CESI has the most to gain by continuation of the process of selecting a Gas Back-up Facility within the context of the RFP Proceeding and the most to lose by deferral of that process to the IRP Proceeding we submit the following for the State Agencies' consideration:

I. CESI Recommends Deferral of Consideration of the Gas Back-up Facility to the IRP Proceeding.

CESI is an active participant in the PJM markets and believes that the prices in those markets give a clear signal of where generation is needed. If PJM market prices indicated that generation was needed in southern Delaware such generation would currently be under construction. Since such generation is not currently under

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construction there is a question of whether it is truly needed. If, and when, market prices support additional generation in southern Delaware merchant generators such as CESI, NRG and others will be sure to consider construction of new facilities. However, unless and until that happens, additional fossil fueled generation will be built in southern Delaware only if such construction is mandated by the State Agencies.

CESI has, at several points throughout the RFP Proceeding, raised the question of whether there is adequate evidence in the record to support a finding that additional fossil fueled generation is needed in southern Delaware. The Commission, within the context of the IRP Proceeding, will develop a comprehensive record upon which to determine Delmarva's power needs. As part of that process the Commission will determine, based upon its analysis of all existing and anticipated available generation resources, whether generation is needed in southern Delaware and, if it is needed, how much capacity and how much energy will be required.

CESI fully understands that consideration of the Gas Back-up Facility within the context of the IRP Proceeding could result in a finding that such a Facility is not needed or that its size and function should be completely different from the Facility upon which CESI based its Back-up Proposal. CESI also understands that, upon completion of the IRP Proceeding, the Commission may reject all bids for back-up supply submitted within the context of the RFP Proceeding and direct Delmarva to seek bids from a wider range of potential suppliers. Thus, this recommended deferral of consideration of the Gas Back-up Facility to the IRP Proceeding puts at risk CESI's potential selection as the back up supplier.

However, CESI is willing to take that risk based upon (i) its desire to see the Commission make sure that there is an adequate record upon which to find that additional fossil fueled generation is required in southern Delaware and (ii) its confidence in its ability to continue to successfully bid on any RFP issued by Delmarva for generation needed in southern Delaware or anywhere else in the State. CESI hopes that NRG agrees that the State Agencies should not require construction of new fossil fueled generation in southern Delaware without benefit of an adequate record. CESI, therefore, calls upon NRG to join it in recommending to the State Agencies that they defer final consideration of the Gas Back-up Facility to the IRP Proceeding where such a record is being created.

II. If the State Agencies Decide to Consider the Gas Back-up Facility within the Context of the RFP Proceeding, CESI's Back-up Proposal Should be Selected.

The term sheets filed with the State Agencies on September 14, 2007 would have created a 300 MW block of power consisting of 105 MW of capacity and up to 300 MW of energy in any hour provided by Bluewater and 195 MW of capacity and the difference

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between 300 MW of energy and the energy delivered by Bluewater in any hour being provided by the back-up service provider. Now that Delmarva and Bluewater have executed the Wind Power PPA consisting of 200 MW of power, it can be inferred that the Hybrid Approach will consist of a 200 MW block of power consisting of 70 MW¹ of capacity and up to 200 MW of energy in any hour provided by Bluewater and 130 MW of capacity the difference between 200 MWh of energy and the energy delivered by Bluewater in any hour being provided by the back-up service provider.

The CESI and NRG term sheets both used very similar methods of meeting the back-up requirements. With respect to capacity, both offered to sell 195 MW of capacity at a fixed price for the 25 years of the agreement. Presumably, both would now reduce that quantity to 130 MW to meet the reduced size of the wind project. With respect to energy, neither CESI nor NRG proposed to operate its facility to match the back-up energy requirements of the wind project. Instead, both offered to meet the energy requirement from the market and to provide a price hedge for that energy during hours when LMP exceeded the operating costs of their respective facility. Thus, the price difference between the two back-up proposals was equal to the sum of (i) the difference between the proposed capacity prices and (ii) the difference between the benefits provided by the price hedges.

NRG offered a capacity price of \$23.85/kW-month (consisting of a fixed price of \$19.25/kW-month and an additional estimated \$4.60/kW-month for gas transportation). CESI offered a capacity price of \$11.27/kW-month (consisting of a fixed price of \$10.65/kW-month and an additional \$0.62/kW-month adder for the estimated cost of interconnection). If the Gas Back-up Supplier will be providing 130 MW of capacity, the capacity costs under CESI's proposal are approximately \$19.6 million per year less than under NRG's proposal.²

In addition to the benefit of lower capacity costs, the GE LMS 100 technology proposed by CESI is superior to NRG's proposed combined cycle plant in the following respects: (i) because CESI's project has a two hour minimum run time rather than the six hour minimum run time of NRG's, CESI's price hedge is likely to be effective during numerous short peak usage periods when NRG's will not; (ii) because NRG's project has a five hour cold start time rather than the 10 minute start time of CESI's project, NRG has proposed start charges that were not proposed by CESI; and (iii) because CESI's project can be operated multiple times in the same day while NRG's project can only be

¹ The number 70 MW does not appear in the Wind Power PPA. It is used in this discussion because it is a pro rata adjustment to the 105 MW originally used in the Bluewater term sheet to reflect the fact that the purchase has been reduced from 300 MW to 200 MW. According to the Wind Power PPA, the actual capacity that will be purchased from Bluewater will depend upon a number of factors including the actual capability of the wind farm, PJM rules and the ultimate size of the wind farm.

² $(\$23.85/\text{kW-month} - \$11.27/\text{kW/month}) * 130 \text{ MW-month} * 12 \text{ months} = \$19,624,800$

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operated once, CESI's price hedge is likely to be effective for hours during a second peak usage occurring on the same day while NRG's will not.

NRG initially argued that its price hedge would be more effective than CESI's because it offered to provide its hedge for the entire 300 MW size of its combined cycle plant to match the size of the wind project while CESI offered to provide its hedge only for the 200 MW size of its project. However, because the wind project has been reduced to 200 MW, CESI's project is now sized to meet the entire back-up energy requirements of the project and NRG's combined cycle project is clearly oversized. In other words, any perceived benefit from NRG's offer to provide a price hedge for back-up energy between 200 MW and 300 MW in any hour has now disappeared.

In its review of the term sheets, the State Agencies' consultant found that CESI's back up proposal was \$74 million less expensive than NRG's. While this number may no longer be entirely accurate in light of the reduction in size of the wind farm, its ultimate conclusion – that CESI's proposal is more cost effective than NRG's – should not be affected. If anything, as discussed above, the reduction in the size of the wind farm may have increased the relative benefits of CESI's proposal.

Finally, CESI notes that the price advantage offered by CESI's proposal is not the only reason that CESI's back-up proposal is preferable to NRG's. NRG's proposal had a major contingency that was not a part of CESI's. Specifically, NRG's proposal was contingent upon construction of a gas pipeline crossing the Chesapeake Bay. If the gas pipeline crossing is not complete by 2013, NRG has the right to simply walk away from its contract with Delmarva without penalty.³ In contrast, CESI's proposal was not dependent upon the Bay crossing. Instead, CESI proposed to rely upon upgrades of existing gas pipeline facilities.⁴ CESI's proposal is, thus, unconditional with respect to the availability of gas supply.

The Staff in its Report suggested that siting would be a concern for the CESI project because it did not yet own property rights.⁵ At the time that the Term Sheets were submitted, CESI had an option on a site near Delmar that could be used for the project. It hoped to obtain a site near Bridgeville, which if acquired, would reduce costs for CESI, but would have no impact on the price paid by Delmarva. In order to avoid any confusion, CESI wants to make clear that it is prepared to use the site near Delmar upon which it holds an option. Between now and the time that CESI starts construction it may arrange for an alternative site. However, the selection of such an alternative site would have no impact on the service provided or the cost of such service. Thus, siting of the CESI project is not an issue.

³ October 29, 2007 Staff Report, Appendix A, p. 53.

⁴ October 29, 2007 Staff Report, Appendix A, p. 8.

⁵ October 29, 2007 Staff Report, p. 22.

In light of the above, if the State Agencies re-affirm their determination that a Gas Back-up Facility is needed and that such a Facility should be selected through the RFP Proceeding, CESI urges the State Agencies to direct Delmarva to enter into negotiations with CESI for a Power Purchase Agreement for back-up supply under the terms set forth by CESI in its Back-up Proposal.

III. NRG Should Not Be Permitted to Bid Against CESI's Now-public Back-up Proposal.

On December 17, 2007, after Delmarva submitted the CESI and NRG term sheets and after the content of those term sheets were made public by issuance of the Staff Report, Mr. David L. Davis sent a letter to the State Agencies reiterating NRG's desire to "submit a revised proposal for a peaking facility on substantially the same terms as those set forth in the Conectiv term sheet". If the State Agencies continue the process of selection of the Gas Back-up Facility through the RFP Proceeding, it is fair to assume that NRG will continue to seek the opportunity to compete against the now-public bid originally submitted by CESI. CESI opposes any such distortion of what was supposed to have been a competitive bidding process.

Pursuant to the State Agencies' directive, CESI and NRG each participated in confidential negotiations with Delmarva for the purpose of developing competitive proposals for the provision of back-up supply. This type of sealed bid procedure is used in state procurements to encourage bidders to aggressively develop their lowest and best price without the benefit of knowing how their competitors will be bidding. In contrast, multiple round bid procedures permit bidders to initially bid conservatively and to reduce their bids only in response to bids of their competitors.

During the confidential negotiations both CESI and NRG had equal opportunity to investigate available technologies and to develop their lowest and best offer to meet the requirements for back up service. CESI spent a great deal of time and effort to determine that the LMS 100 equipment was best suited to provide the required service. NRG proposed a combined cycle facility.

After the term sheets were made public and the State Agencies' consultant announced that the costs of CESI's proposal were much lower than NRG's proposal, NRG sought the opportunity to submit its own proposal using CESI's proposed technology. CESI had every reason to believe that its participation in the confidential term sheet negotiation process with Delmarva was as a competitive bidder participating in a sealed bid competition. NRG, as the presumptive loser in the sealed bid process, is now asking the State Agencies to permit it to treat this like a multiple round bid process so that it can try to beat the winning bid already submitted by CESI. If the State

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Agencies grant NRG's request, the competitive bidding process for back up supply can no longer be considered to be a level playing field for competitive participants. Instead, CESI's efforts to develop a competitive proposal will be nothing more than creation of a blueprint to be followed by its competitor.

Therefore, if the State Agencies re-affirm their determination that a Gas Back-up Facility is needed and that such a Facility should be selected through the RFP Proceeding CESI urges the State Agencies to reject NRG's request to revise its term sheet so as to propose a project that attempts to match the one proposed by CESI. CESI cannot overemphasize the fact that, if NRG is permitted to revise its term sheet at this time, CESI will be placed in a very disadvantageous position. Its proposal will simply be a baseline against which NRG will attempt to submit what appears to be a more attractive proposal. Therefore, in the event that the State Agencies permit NRG to revise its term sheet as requested, CESI should also be relieved from its obligation to be bound to the terms of its Back-up Proposal and it should be permitted, at its option, to either resubmit that proposal, submit a new proposal or simply decide to not offer to provide back-up service.

Sincerely,



I. David Rosenstein, General Counsel
Conectiv Energy Supply, Inc.

cc: Service List